

CMA US Notes: Retained Earnings, Revenue Recognition, and Business Combinations

Retained Earnings

Definition

Retained Earnings represent the cumulative undistributed profits of a company since its inception, reflecting net income retained after dividends and other distributions.

Statement of Retained Earnings

The **Statement of Retained Earnings** reconciles the beginning and ending retained earnings balance for a period, adjusted for various items. The structure is as follows:

- **Beginning Retained Earnings (January 1, unadjusted)**
- **Adjustments:**
 - **Cumulative effect of retrospective changes in accounting principles** (e.g., adoption of a new standard).
 - **Cumulative effect of retrospective changes in reporting entity** (e.g., changes in subsidiaries included in consolidation).
 - **Restatement due to error corrections** (e.g., correcting prior period misstatements).
- **Adjusted Beginning Retained Earnings (January 1)**
- **Add:** Net income (or subtract net loss) for the period.
- **Subtract:**
 - Losses from share transactions (e.g., treasury stock transactions at a loss).
 - Dividends declared (cash, stock, or property).
- **Ending Retained Earnings (December 31)**

Example Formula:

Beginning Retained Earnings

+ Net Income (or - Net Loss)

- Dividends Declared

- Losses from Share Transactions

= Ending Retained Earnings

Appropriated Retained Earnings

- **Definition:** The board of directors may **appropriate** (restrict) a portion of retained earnings to reserve funds for specific purposes (e.g., future expansion, debt repayment, or contingencies).
- **Purpose:** Signals to financial statement users that certain retained earnings are **not available for distribution** as dividends.

- **Accounting:**
 - No cash is moved; this is a reclassification within equity.
 - **Journal Entry** (e.g., appropriating \$50,000 for a future project):
- Dr Retained Earnings 50,000
- Cr Appropriated Retained Earnings 50,000
 - Reversal (when restriction is lifted):
- Dr Appropriated Retained Earnings 50,000
- Cr Retained Earnings 50,000

Revenue Recognition

Objective

The **revenue recognition standard** under **ASC 606** provides a single, comprehensive model to ensure consistency in recognizing revenue from contracts with customers across industries and jurisdictions.

Revenue Recognition Principle

Revenue is recognized when (or as) a **performance obligation** is satisfied, i.e., when control of a promised good or service transfers to the customer.

Five-Step Revenue Recognition Process

1. **Identify the Contract with a Customer:**
 - A contract is an agreement creating enforceable rights and obligations.
 - Criteria: Approval by all parties, identifiable payment terms, commercial substance, and collectibility is probable.
2. **Identify the Performance Obligations:**
 - Promises to transfer distinct goods or services (or bundles of goods/services) to the customer.
 - A good or service is **distinct** if the customer can benefit from it independently and it is separately identifiable.
3. **Determine the Transaction Price:**
 - The amount of consideration the company expects to receive.
 - Includes fixed amounts, variable consideration (e.g., discounts, rebates), and non-cash consideration, adjusted for the time value of money if significant.
4. **Allocate the Transaction Price to Performance Obligations:**
 - Allocate based on the **standalone selling price** of each performance obligation.
 - If standalone prices are not observable, estimate using methods like adjusted market assessment or expected cost plus margin.

5. Recognize Revenue When (or as) Performance Obligations Are Satisfied:

- Revenue is recognized when control transfers, either **over time** (e.g., services) or at a **point in time** (e.g., goods).
- Over-Time Criteria:**
 - Customer simultaneously receives and consumes benefits.
 - Company's performance creates an asset with no alternative use, and the company has an enforceable right to payment.
 - Customer controls the asset as it is created.

Contract Assets and Liabilities

- Contract Assets:**
 - Unconditional:** Rights to consideration after satisfying a performance obligation (e.g., receivables).
 - Conditional:** Rights to consideration for satisfied obligations, but additional obligations remain before invoicing (e.g., unbilled revenue).
- Contract Liabilities:** Obligations to transfer goods/services for which the company has received consideration (e.g., deferred revenue).

Special Revenue Recognition Situations

1. Contracts with Right of Return:

- Variable consideration; exclude revenue for expected returns or refunds.
- Record a refund liability and an asset for the right to recover returned goods.
- Journal Entry** (e.g., \$10,000 expected returns):

2. Dr Sales Revenue 10,000

3. Cr Refund Liability 10,000

4. Dr Right to Recover Asset [Cost of goods]

5. Cr Inventory [Cost of goods]

6. Consigned Goods:

- Revenue is not recognized until the consignee sells the goods to a third party, as the consignor retains control.
- Consignor records goods as inventory until sold.

Long-Term Contracts

Methods of Revenue Recognition

1. Over-Time Recognition:

- Revenue, costs, and profit are recognized as the contract progresses, based on the percentage of completion.
- Criteria:**
 - Customer simultaneously receives and consumes benefits.
 - Asset has no alternative use, and the company has a right to payment for work performed.
- Cost-to-Cost Method:**
 - Percentage complete = $\text{Costs incurred to date} \div (\text{Costs incurred} + \text{Estimated costs to complete})$.
 - Profit recognized = $(\text{Estimated gross profit} \times \text{Percentage complete}) - \text{Profit previously recognized}$.
 - Journal Entry** (e.g., recognizing revenue):
- Dr Construction in Process (CIP) [Costs incurred + Profit]
- Cr Revenue [Revenue recognized]
- Cr Cash/Accounts Payable [Costs incurred]

2. Point-in-Time Recognition:

- Revenue, costs, and profit are recognized when the customer obtains control of the asset.
- Construction in Process (CIP):** Accumulates costs incurred during the contract.
- Billings on Construction in Process (BCP):** Records invoices issued; not a revenue account.
- Journal Entry for Invoicing:**
- Dr Accounts Receivable [Invoice amount]
- Cr Billings on Construction in Process (BCP) [Invoice amount]
- Balance Sheet Reporting:**
 - Net CIP and BCP as a **contract asset** (if CIP > BCP) or **contract liability** (if BCP > CIP).
- Closing Out Point-in-Time Contract:**
- Dr Billings on Construction in Process (BCP) [Total billings]
- Dr Construction Expense [Total costs]
- Cr Construction in Process (CIP) [Total costs]
- Cr Revenue on PIT Contracts [Total billings]

Estimated Losses

- **Over-Time:** Recognize the entire estimated loss immediately when it becomes apparent.
- **Point-in-Time:** Recognize the loss when the contract is completed.
- **Journal Entry for Loss** (e.g., \$50,000 estimated loss):
- Dr Loss on Contract 50,000
- Cr Construction in Process 50,000

Business Combinations and Consolidations: Revenue Recognition Example

Problem

Scenario: On January 1, 2025, Parent Co. acquires 100% of Sub Co. for \$1,500,000 in cash. Sub Co.'s net assets have a fair value of \$1,200,000, including a customer contract (intangible asset) valued at \$200,000, which generates revenue over 4 years. Sub Co. has a long-term contract with a customer, with a total contract price of \$400,000. As of acquisition, \$100,000 in costs have been incurred, and estimated remaining costs are \$150,000. Using the cost-to-cost method, calculate goodwill and the revenue recognized for 2025 if an additional \$75,000 in costs is incurred.

Solution:

1. **Goodwill Calculation:**
 - Purchase price: \$1,500,000
 - Fair value of net assets: \$1,200,000
 - Goodwill = \$1,500,000 - \$1,200,000 = **\$300,000**
2. **Consolidation Journal Entry:**
3. Dr Assets (excluding customer contract) 1,000,000
4. Dr Customer Contract 200,000
5. Dr Goodwill 300,000
6. Cr Cash 1,500,000
7. **Revenue Recognition (Cost-to-Cost Method):**
 - **Total estimated costs** = \$100,000 (incurred pre-acquisition) + \$150,000 (estimated remaining) = \$250,000
 - **Estimated gross profit** = Contract price (\$400,000) - Total estimated costs (\$250,000) = \$150,000
 - **Costs incurred in 2025** = \$75,000
 - **Total costs incurred to date** = \$100,000 + \$75,000 = \$175,000
 - **Percentage complete** = \$175,000 ÷ \$250,000 = 70%
 - **Revenue to recognize in 2025** = (\$400,000 × 70%) - \$0 (no prior revenue recognized) = \$280,000
 - **Profit to recognize in 2025** = (\$150,000 × 70%) = \$105,000

- **Journal Entry:**
- Dr Construction in Process (CIP) 180,000 [\$75,000 costs + \$105,000 profit]
- Cr Revenue 280,000
- Cr Cash/Accounts Payable 75,000

8. Consolidation Notes:

- Eliminate Sub Co.'s equity accounts during